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TAX POLICY IN THE BUSH ADMINISTRATION: 2001-2004

William G. Gale and Peter R. Orszag

Brookings Institution and Tax Policy Center

February 2004

This paper examines tax policy in the Bush Administration. After describing the key elements of the tax cuts enacted since 2001, the paper examines the impact of the tax changes on the federal budget, the distribution of tax burdens and after-tax income, economic growth, complexity, government spending, and fundamental tax reform. We also examine interactions between the tax cuts and the alternative minimum tax. We conclude that many of the ultimate effects of the tax cut will depend on how it is financed -- with either spending cuts or future tax increases.

William G. Gale, Brookings Institution

Bill Gale is a Senior Fellow and holds the Arjay and Frances Miller Chair in Federal Economic Policy in the Economic Studies Program at the Brookings Institution. He is deputy director of the Economic Studies Program and co-director of the Tax Policy Center, a joint venture of the

Brookings Institution and the Urban Institute. His areas of expertise include tax policy, budget and fiscal policy, and public and private saving behavior and pensions, and intergenerational transfers of wealth.

Before joining Brookings, Gale was an assistant professor in the Department of Economics at the University of California at Los Angeles, and a senior staff economist for the Council of Economic Advisers. He has also served as a consultant to the General Accounting Office and the World Bank.

Gale is co-editor of *Rethinking Estate and Gift Taxation* (2001), *Economic Effects of Fundamental Tax Reform* (1996), the *Brookings-Wharton Papers on Urban Affairs*, (1999-present) and two forthcoming volumes: *The Evolving Pension System: Trends, Effects, and Proposals for Reform and Private Pensions and Public Policies*, all published by Brookings.

Gale is author or co-author of numerous academic articles including: "An Economic Evaluation of EGTRRA," *National Tax Journal* (2002), "Perspectives on the Budget Surplus," *National Tax Journal* (2000), "The Adequacy of Retirement Saving," *Brookings Papers on Economic Activity* (1999), "The Effects of Pensions on Household Wealth," *Journal of Political Economy* (August 1998), "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives* (Fall 1996), "IRAs and Household Saving," *American Economic Review* (December 1994), "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives* (Fall 1994), "Economic Effects of Federal Credit Programs," *American Economic Review*, (March 1991). He has also published in a wide variety of popular media outlets, including the *Los Angeles Times*, the *New York Times*, the *Wall Street Journal*, and the *Washington Post* and currently writes a periodic column called "Tax Break" for the journal *Tax Notes*.

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PROGRESSIVE TAXATION AND HAPPINESS

Thomas D. Griffith

John B. Millikin Professor of Taxation

University of Southern California Law School

The strongest argument for progressive taxation is that transferring income from richer to poorer individuals through a combination of taxation and government spending increases total welfare in the society. The reason is simple: additional income produces more utility for a poor person than a rich person. Progressive taxation also, however, may be costly. The higher marginal rates required to fund redistribution may reduce work effort and encourage individuals to engage in costly and nonproductive activities to shelter their income from taxation. The gains in social welfare from redistributing income to the poor, then, must be weighed against the losses in social welfare from reduced work effort. This Article focuses on one half of that balance the potential gains

from redistribution and considers the following questions. How much, if at all, does redistributing income from the rich to the poor increase total happiness in the society? Is the answer different in wealthy societies than in poor societies? If redistributive tax and spending policies slow economic growth, does such a slowdown significantly reduce total happiness in the society? More broadly, what is the relationship between economic conditions in a society and the happiness of the members of that society? Until recently there was little serious scholarship focusing on such questions. Over the past two decades, however, there has been an explosion of what might be called happiness studies research on the determinants of human happiness. This Article examines some of the central findings of this literature and considers their implications for redistributive tax and spending policies.

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Thomas D. Griffith, University of Southern California Law School

Thomas Griffith is the John B. Millikin Professor of Taxation at the University of Southern California Law School. He attended Harvard Law School where he was an editor on the *Harvard Law Review*. After graduation he practiced law in Boston before joining the USC faculty in

1984. He teaches and writes in the areas of Taxation and Criminal Law. His publications in the area of taxation include Social Welfare and the Rate Structure: A New Look at Progressive Taxation (with Joseph Bankman); Efficient Taxation of Mixed Personal and Business Expenses; Should Tax Norms Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries; and Theories of Personal Deductions in the Income Tax. His most recent publication is Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities (with Michael S. Knoll).

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THE MATTHEW EFFECT AND FEDERAL TAXATION

Martin J. McMahon, Jr.

Clarence J. TeSelle Professor

University of Florida College of Law.

"For whosoever hath, to him shall be given, and he shall have more abundance; But whosoever hath not, from him shall be taken away even that he hath." -- Gospel of Matthew, chapter 25, verse 29.

The term the "Matthew effect," was coined by sociologist Robert K. Merton in 1968 based on the passage from the Gospel of Matthew in the epigram. "Put in less stately language, the Matthew effect consists in the accruing of greater increments of recognition for particular scientific contributions to scientists of considerable repute and the withholding of such recognition from scientists who have not yet made their mark." The Matthew effect is not limited to the context in which Robert Merton first coined it. More generally, it is a synonym for the well known colloquial aphorism, "the rich get richer and the poor get poorer." This article is about the Matthew effect in the distribution of incomes in the United States, and the failure of the federal tax system to address the Matthew effect.

Over twenty years ago Paul Samuelson observed, "[i]f we made an income pyramid out of a child's blocks, with each layer portraying \$ 1,000 of income, the peak would be far higher than the Eiffel Tower, but most of us would be within a yard of the ground." Things have changed little since then. The peak is higher, but most people are still in essentially the same place. During the last two decades of the Twentieth Century the distribution of incomes and wealth in the United States reached levels of inequality that have not been seen since the Roaring Twenties. Although the "Roaring Nineties" might have been "the world's most prosperous decade," as described by Joseph Stiglitz, the prosperity was not spread around. The data indicate that a very small number of people garnered an overwhelming amount of the increase in incomes and wealth in that decade, as well as in the prior decade.

During the 1950s and 1960s, family income inequality decreased, but the tide changed after 1969, and through the last three decades of the twentieth century income inequality increased. Nevertheless, the federal tax system did little to ameliorate the increasing economic inequality. As of 2000, the redistributive effect of the income tax was somewhat less than it was in the early 1980s, although it was somewhat greater than it was in the early 1990s. As we move into the new Millennium, however, recent changes in the federal tax system presage a decreasing role not only in redistribution, but in mitigation of vast disparities in income and wealth. Since the inauguration of the Bush administration in 2000, there have been three major tax acts, which have reduced significantly the tax burden of the super-rich, while handing out small change to everyone else.

This article first examines in detail the increasing concentration of income and wealth in the top one percent, and particularly within much narrower cohorts near the top of the top one percent, that has occurred over the past twenty-five years. It demonstrates the strong Matthew effect in incomes in the United States over that period. The super-rich are pulling away from everyone by so much and at a rate so fast that the fact that incomes of many households at the bottom and in the middle have stagnated, or even fallen in constant dollars, has been obscured by ever increasing per capita income — a false talisman of progress because it obscures distributional issues.

The article then examines changing effective federal tax rates over the last two decades of the twentieth century. It discusses relevant legislative changes and the shifting tax burdens, as measured by effective tax rates on different income cohorts, of the various federal taxes individually and collectively. The article demonstrates that by the close of the twentieth century the tax system was not raising revenue as fairly and was doing less to mitigate inequality than it had in the middle of that century.

Moving into the new century, the Republican tax policy, as embodied in tax legislation enacted in 2001 through 2003, provides tax cuts very disproportionately favor those at the top of the income pyramid with very small tax cuts going to everyone else, even the upper middle class and the merely rich, in contrast to the super-rich.

The article demonstrates that economic theory does not support the argument that the tax cuts were necessary to spur incentives to save and invest and to work, and that the empirical evidence of the effect of tax cuts on savings and investment clearly contradicts the claims made by supporters of the tax cuts. It examines the rapidly growing body of economic literature supporting the thesis that economic inequality impedes economic growth rather than fostering it, and concludes that because the tax cuts increase inequality, they probably impede economic growth. The article then examines empirical data that debunks the notion that "a rising tide lifts all boats."

After analyzing the economic issues, the article discusses the philosophical basis for a highly redistributive tax system, arguing that in a modern industrialized democracy, most of what everyone earns is attributable to infrastructure created by society acting as a whole, principally through government. It rejects the notion that individuals have the first claim to everything that they earn and adopts a more communitarian approach. The article then examines the paradox of public concern with increasing economic inequality, thinking it undesirable, and while simultaneously supporting tax cut legislation that in fact delivers vastly disproportionate benefits to the super-rich.

Finally, the article suggests that its time for the tax system to address these problems by substantially increasing progressivity at the top of the income pyramid. Marginal tax rates should be increased for incomes in excess of \$500,000, and as incomes increase to progressively higher levels, additional rate brackets should be added to impose substantially higher marginal rates on incomes in excess of \$1,000,000, and particularly on incomes that exceed \$5,000,000. Future tax legislation ought to mitigate the Matthew effect, rather than enhance it.

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Martin J. McMahon, Jr., University of Florida College of Law

Martin McMahon is the Clarence J. TeSelle Professor of Law at the University of Florida College of Law, where he teaches in the Graduate Tax Program. He received a B.A. in economics from Rutgers University, a J.D. from Boston College Law School, and an LL.M. in Taxation from Boston University Law School. Professor McMahon taught previously at the University of Kentucky, has been a visiting professor at the University of Virginia, was the Professor-in-Residence in the Office of Chief Counsel of the Internal Revenue Service in 1986 and 1987, and has been an instructor in the NYU/IRS Continuing Professional Education Program.

He is the co-author with Boris Bittker and Lawrence Zelenak of *Federal Income Taxation of Individuals* (Warren, Gorham & Lamont 2002, 3d ed.), with Larry Zelenak of *Federal Income Taxation of Individuals Study Problems*, and with Paul McDaniel, Hugh Ault and Daniel Simmons of four textbooks, *Federal Income Taxation* (Foundation Press, 1994, 2d ed., 1998), *Federal Income Taxation of Business Organizations* (Foundation Press 1991, 2d ed. 1997, 3d ed., 1999), *Federal Income Taxation of Corporations* (Foundation Press 1997, 2d ed., 1999), and *Federal Income Taxation of Partnerships and S Corporations* (Foundation Press, 1991, 2d ed., 1997, 3d ed., 1999). In addition to publishing over forty articles on various income taxation issues, Professor McMahon is a frequent speaker at tax conferences around the

country. He has been chair of the Teaching Taxation Committee of the ABA Tax Section and the Tax Section of the Association of American Law Schools, and is a fellow in the American College of Tax Counsel and the American Law Institute.

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RECKLESS DISREGARD: THE BUSH ADMINISTRATION'S POLICY OF CUTTING TAXES IN THE FACE OF AN ENORMOUS FISCAL GAP

Daniel N. Shaviro

New York University School of Law

The Bush Administration's policy of sharply cutting taxes while increasing government spending is both misguided and harmful. Presumably rationalized as a way of shrinking government over the long term without paying a current political price, it in fact increases the government's distributional intervention by handing money to current voters at the expense of younger and future generations. The Bush policies have increased the future tax increases that are likely to be necessary. In addition, they are likely to require additional Social Security and Medicare cuts that can be seen in large part as negative taxes, refunding some of the positive lifetime net taxes that future retirees will by then have paid. Reducing future negative taxes is a lot like increasing future positive ones. Finally, the Bush policies may lead to an Argentina-style meltdown in the U.S. government's position as a borrower in world capital markets, potentially yielding chronic inflation, unemployment, and bank and currency crises that affect our economic productivity for an indefinite period.

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Daniel N. Shaviro, New York University School of Law

Daniel Shaviro is the Wayne Perry Professor of Taxation at New York University Law School. His research has mainly emphasized income tax policy, government transfers, budgetary measures, social insurance, and entitlements reform. Books that he has written include *Do Deficits Matter?* (1997), *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (2000), *Making Sense of Social Security Reform* (2000), and *Who Should Pay for Medicare?* (forthcoming 2004), all published by the University of Chicago Press.

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Marjorie E. Kornhauser, Tulane Law School

Marjorie E. Kornhauser is a Professor of Law at Tulane Law School. Her research, focusing on the relationship between tax and society, examines tax policy from various perspectives including the historical, political, philosophical and social. Her numerous published articles include:

- Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America, 50 Buff. L. Rev. 819 (2002).
- The Story of Macomber: The Continuing Legacy of Realization, in *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases*, (Paul Caron, ed., Foundation Press, 2002).
- For God and Country: Taxing Conscience, 1999 Wis. L. Rev. 939.
- The Morality of Money: U.S. Attitudes Towards Wealth and the Income Tax 70 Ind. L. J. 119 (1994).
- Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return, 45 Hastings L. J. 63 (1993).
- The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction, 86 Mich. L. Rev. 465 (1987).

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Lawrence Lokken, University of Florida College of Law

Lawrence Lokken is the Hugh H. Culverhouse Eminent Scholar in Taxation and Professor of Law at the University of Florida College of Law. He has taught at the University of Florida College of Law since 1994. Other teaching experience includes the University of Georgia from 1968-70, University of Florida from 1974-80, and the New York University from 1980-93. Professor Lokken has also been a visiting faculty member at the University of Minnesota, Duke University, Southern Methodist University, the University of Leiden (the Netherlands), Munster University (Germany), Rand Afrikaans University (South Africa), and Warsaw University (Poland).

Professor Lokken is coauthor of Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (1990-2003), a five volume treatise on U.S. income, gift, and estate tax laws, and of a one volume work, Boris I. Bittker & Lawrence Lokken, *Fundamentals of International Taxation* (2003).

Professor Lokken received his B.A., cum laude, from Augsburg College, and his J.D., magna cum laude, from the University of Minnesota.

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Paul R. McDaniel, Boston College Law School

Paul McDaniel is an internationally-recognized expert in tax law. He is the co-author of 8 books and the author or co-author of over 50 articles. His recent scholarly work has focused on the interaction between trade agreements and income taxation. Among his many contributions to tax, Professor McDaniel helped pioneer the concept of tax expenditures with the late Stanley Surrey of Harvard, exploring these issues in the groundbreaking book *Tax Expenditures*.

Professor McDaniel practiced in Oklahoma upon graduation from Harvard Law School in 1961. In 1967, he joined the staff of Surrey, then Assistant Secretary for Tax Policy at the U.S. Treasury Department. He was a member of B.C. Law School faculty from 1970 – 1987, after which he joined the Boston law firm of Hill & Barlow as Chair of the firm's Tax Department. McDaniel joined the faculty of the NYU School of Law in 1993 and served as Director of the Graduate Tax Program and the International Tax Program. Professor McDaniel received an honorary Doctor of Laws degree from the University of Uppsala. He rejoined the B.C. Law faculty in 2002.

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James R. Repetti, Boston College Law School

James Repetti teaches four tax courses at Boston College Law School. He is co-author of the texts, *Federal Wealth Transfer Taxation* (2003) and *Problems in Federal Wealth Transfer Taxation* (2003), and is also co-author of a treatise on international partnership taxation. His recent law review articles include: *Democracy, Taxes and Wealth*, 76 NYU L. REV. 825 (2001) and *Textualism and Tax Shelters*, VA TAX REV. (forthcoming, with Noel Cunningham). He is also co-author of the forthcoming book, *Introduction to United States International Taxation* (5th ed. 2004) (with Paul R. McDaniel & Hugh J. Ault) and a contributing author of the forthcoming book, *Comparative Income Taxation: A Structural Analysis* (2nd ed. 2004) (Hugh J. Ault & Brian Arnold, Principal Authors).

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Diane M. Ring, Harvard Law School

Diane M. Ring is an Assistant Professor of Law at the Harvard Law School, where she researches and writes primarily in the field of international taxation. Her recent work addresses issues including cross border tax arbitrage, advance pricing agreements, and international tax relations. Ms. Ring is the U.S. National Reporter for the 2004 IFA Conference on Double Nontaxation. She was the Assistant General Reporter for the 1995 IFA Conference on Financial Instruments and was a consultant to the IFA research project on the impact of technological

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Prior to joining the Harvard Law School, Ms. Ring practiced at the firm of Caplin & Drysdale in Washington, D.C., specializing in the area of international tax and the taxation of financial instruments. Ms. Ring also clerked for Judge Jon O. Newman of the Second Circuit Court of Appeals.

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Deborah Schenk is the Marilynn and Ronald Grossman Professor of Taxation at NYU School of Law. She joined the NYU faculty in 1983, having previously been a professor at Brooklyn Law School and a visiting professor at Harvard and Yale Law Schools. She is the Editor-in-Chief of the Tax Law Review, a tax policy journal. Professor Schenk has written numerous articles on tax policy, and authored three books: Federal Income Taxation of S Corporations, Federal Income Taxation: Principles and Policies (with Michael Graetz), and Ethical Problems in Federal Tax Practice (with Bernard Wolfman and James Holden). Professor Schenk is a past member of the Council of the ABA Tax Section, the Executive Committee of the NYS Bar Association Tax Section, and a Trustee of the American Tax Policy Institute. She is a current member and a past chair of the NYS Bar Association's Committee on Professional Ethics, a member of the Board of Directors of Tax Analysts, and a member of the ALI and the American College of Tax Counsel.

Ms. Schenk received her B.A. from Cornell University, her J.D. from Columbia Law School, and her L.L.M. in taxation from New York University School of Law.

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Richard L. Schmalbeck, Duke University School of Law

Richard Schmalbeck is Professor of Law at Duke University. He has also served as Dean of the University of Illinois College of Law, and as a visiting professor on the University of Michigan and Northwestern University law faculties. His recent scholarly work has focused on issues involving nonprofit organizations, and the federal estate and gift taxes. He has also served as an advisor to the Russian Federation in connection with its tax reform efforts. His new income tax casebook, co-authored with Lawrence Zelenak, has just been released by Aspen Publishers.

He graduated from the University of Chicago, and later from its Law School, where he served as Associate Editor of the University of Chicago Law Review. Prior to beginning his teaching career, he worked as a special assistant to the Associate Director of the Office of Management and Budget, and as an associate in the Washington law firm of Caplin & Drysdale.

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Linda Sugin, Fordham University School of Law

Linda Sugin is an Associate Professor at Fordham Law School, where she teaches Income Taxation, Tax Policy, Nonprofit Organizations, and Corporate Law. She is a graduate of Harvard College and NYU Law School, where she has been both an Acting Assistant Professor (1992-94) and a Visiting Professor (2001-02). She is co-author of a textbook for the basic tax course, The Individual Tax Base.

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David I. Walker, Boston University School of Law

David I. Walker is an Associate Professor of Law at Boston University School of Law. Professor

Walker teaches courses in taxation, executive compensation, and law and economics, and his research and writing reflect those interests. Recent projects include “Is Equity Compensation Tax Advantaged?” forthcoming in the Boston University Law Review, and “Managerial Power and Rent Extraction in the Design of Executive Compensation,” co-authored with Lucian Bebchuk and Jesse Fried and published in the University of Chicago Law Review.

Professor Walker is a magna cum laude graduate of Harvard Law School and a recipient of that school’s John M. Olin Prize in Law and Economics. After graduating in 1998, he clerked for Judge Karen Nelson Moore of the U.S. Court of Appeals for the Sixth Circuit and then returned to Harvard Law School for a year as an Olin Fellow. Immediately prior to joining the law faculty at Boston University in the fall of 2002, Professor Walker was an associate in the tax department at Ropes & Gray, where he had a general tax practice with an emphasis on executive compensation. Before attending law school, Professor Walker enjoyed an interesting and varied career in the oil industry that included roles as a chemical engineer, crude oil trader, and assistant to the president of BP Oil Company, the U.S. arm of British Petroleum.

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